

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

Number: **201220004**
Release Date: 5/18/2012

[Third Party Communication:
Date of Communication: Month DD, YYYY]
Person To Contact:
, ID No.
Telephone Number:

Index Number: 446.32-00

Refer Reply To:
CC:FIP:B03
PLR-107239-11
Date:
February 14, 2012

Taxpayer =

Court =

a =

b =

c =

Month 1 =

Date 2 =

Date 3 =

Year X =

Year Y =

Dear :

This letter responds to your letter dated February 15, 2011 requesting a ruling that Taxpayer's unamortized debt issuance costs are deductible as a separate item and do not affect the Taxpayer's determination of cancellation of indebtedness income realized

upon the cancellation or exchange of the debts to which they relate pursuant to the Bankruptcy Plan.

FACTS

Beginning in Month 1, Taxpayer entered into a series of transactions through which it converted from a C corporation to an S corporation. Taxpayer elected to be taxed as an S corporation pursuant to section 1362(a) effective for its tax year beginning on Date 2. Taxpayer was an accrual method taxpayer prior to its S election and continues to be an accrual method taxpayer after its S election.

On Date 3, Taxpayer filed in Court for bankruptcy protection under Chapter 11 of the United States Bankruptcy Code. Immediately prior to Taxpayer's bankruptcy filing, Taxpayer had approximately \$a of assets and approximately \$b of liabilities.

Taxpayer expects that Court will confirm a plan of reorganization (the "Bankruptcy Plan") pursuant to which, on the effective date of the Bankruptcy Plan (the "Effective Date"), Taxpayer will issue a combination of cash, new debt ("New Debt") and stock to creditors holding Taxpayer's existing indebtedness. The transaction will generate substantial cancellation of indebtedness ("COD") income to Taxpayer, which Taxpayer expects to exclude under the bankruptcy exception of section 108(a)(1)(A). Because many of the recipients of stock will not qualify to own stock of an S corporation, Taxpayer will become a C corporation on the Effective Date.

Taxpayer had approximately \$c of unamortized debt issuance costs at the end of Year Y, consisting primarily of underwriting fees incurred in connection with the issuance of debt in Year X. Taxpayer has requested a ruling that these costs are deductible as a separate item and are not taken into account to determine the amount of COD income realized upon the cancellation or exchange of the existing indebtedness to which the costs relate.

LAW AND ANALYSIS

Debt issuance costs (such as underwriting costs, commissions, and other costs related to the issuance of a debt instrument) generally are capitalized and amortized or deducted over the term of the debt instrument to which the costs relate. For example, see Enoch v. Commissioner, 57 T.C. 781 (1972). Such capitalized costs generally are deductible each year under section 162. Prior to the issuance of § 1.446-5 of the Income Tax Regulations, debt issuance costs generally were amortized or deducted over the term of the debt instrument based on a straight-line method. However, in order to conform the rules for debt issuance costs with the rules for original issue discount ("OID"), § 1.446-5 was issued to generally require the use of a constant yield method to determine how much of the costs are deductible each year by the borrower. See the preamble to the proposed regulations under REG-125638-01, 67 F.R. 77701, 77710, 2003-1 C.B. 373, 383 (December 19, 2002).

Section 1.446-5 provides specific rules to allocate “debt issuance costs” over the term of the debt instrument to which the costs relate. Debt issuance costs are defined as those transaction costs incurred by an issuer of debt that are required to be capitalized under § 1.263(a)-5. Under § 1.263(a)-5(a)(9), an issuer of debt must capitalize amounts paid to facilitate a borrowing (for example, underwriting costs, commissions, and other costs related to the issuance of a debt instrument). If these costs are otherwise deductible, they are deductible over the term of the debt instrument as determined under § 1.446-5(b). Section 1.446-5(a).

Section 1.446-5(b)(1) provides as follows:

- (1) *In general.* Solely for purposes of determining the amount of debt issuance costs that may be deducted in any period, these costs are treated as if they adjusted the yield on the debt. To effect this, the issuer treats the costs as if they decreased the issue price of the debt. See § 1.1273-2 to determine issue price. Thus, debt issuance costs increase or create original issue discount. . . .

Section 1.446-5(b)(2) provides that any resulting OID is taken into account by the borrower under the rules in § 1.163-7, which generally require the use of a constant yield method (as described in § 1.1272-1) to compute how much OID is deductible for a period. However, § 1.163-7(b) provides special rules that apply if the total amount of OID on the debt instrument is de minimis (for example, if de minimis, the borrower can allocate the costs over the term of the debt instrument based on a straight-line method).

The first two sentences in § 1.446-5(b)(1) indicate that OID treatment of debt issuance costs is intended only to apply for timing purposes. Although the last sentence of § 1.446-5(b)(1) refers to the increase or creation of OID, this reference is intended to clarify that the hypothetical adjustment to the issue price of a debt instrument is used to determine the total amount of OID on the debt instrument (including the “OID” attributable to the capitalized debt issuance costs created by the issue price rule). This total amount of OID then is used to determine which rule under § 1.163-7 will apply to determine the amount of debt issuance costs deductible in a particular period (constant yield or the special rules for de minimis OID). Accordingly, under § 1.446-5, debt issuance costs are intended to be treated by the issuer as OID only to determine the amount of the costs deductible each year over the term of the debt instrument.

Moreover, the preamble to the proposed regulations indicates that § 1.446-5 was not intended to change existing law relating to the treatment of debt issuance costs. See the preamble to the proposed regulations under REG-125638-01, 67 F.R. 77701, 77710, 2003-1 C.B. 373, 383 (December 19, 2002). [The final § 1.446-5 regulations were adopted without significant changes by T.D. 9107, 69 F.R. 436 (January 5, 2004).] As a result, the regulations did not change the prior treatment of debt issuance costs as costs deductible under section 162 (if the debt issuance costs were converted into OID for all purposes, then the costs would be deductible under section 163 rather than under

section 162 and would be subject to any limitations under section 163). In addition, the costs do not affect the determination of a taxpayer's cancellation of indebtedness income under § 1.61-12(c)(2)(ii) (that is, the issue price adjusted by the debt issuance costs used for purposes of § 1.446-5 is not used for purposes of determining the issuer's adjusted issue price for purposes of § 1.61-12(c)(2)(ii)). As a result, unamortized debt issuance costs are not taken into account to determine the amount of COD income realized by a taxpayer upon the cancellation or exchange of the debts to which they relate and are deductible under § 162 as an item separate from the determination of the amount of COD income.

CONCLUSION

Based on the above, we rule that Taxpayer's unamortized debt issuance costs will be deductible as a separate item and will not be taken into account to determine the amount of COD income realized by Taxpayer upon the cancellation or exchange of the debts to which they relate pursuant to the Bankruptcy Plan.

Except as specifically ruled upon above, no opinion is expressed concerning any federal income tax consequences relating to the facts herein under any other provision of the Internal Revenue Code. No opinion is expressed as to when the unamortized debt issuance costs are deductible by Taxpayer.

This ruling is directed only to the taxpayer requesting it. Taxpayer should attach a copy of this ruling to each tax return to which it applies. Section 6110(k)(3) provides that this ruling may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

William E. Blanchard
Senior Technician Reviewer, Branch 3
(Financial Institutions & Products)

cc: